

## Investment Treaties and Industrial Policy:

### Select Case Studies on State Liability for Efforts to Encourage, Shape and Regulate Economic Activities in Extractive Industries and Infrastructure

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## I. INTRODUCTION

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The challenges for governments in designing and implementing industrial policies are well-documented. There is, on the one hand, a tension between efforts to advance a vision of long-term development and, on the other, concerns that investing resources in a particular strategy might turn out to have been misguided. Complicating those issues, there are also tensions between government actions aimed at encouraging and facilitating economic activities, and the government's role as a regulator of those activities. More specifically, governments are faced with the task of balancing efforts to attract, promote and sustain business activities alongside efforts to ensure that broader policy aims are served by, for example, ensuring companies comply with laws on taxation, labor standards, environmental protection, and consumer rights.

But governments have successfully navigated those issues, actively shaping and promoting strategies for sustainable growth of their economies, and doing so through various roles as commercial actors, economic strategists, and guardians of the public interest. Scrutiny over the way governments are performing these actions, however, is increasing.

In particular, over roughly the past 15 years, a new regime has emerged that gives individuals and enterprises enhanced protections from government conduct that hurts their profits. This is the regime that has been created by thousands of bilateral and multilateral investment treaties concluded by developed and developing countries worldwide, and the decisions issued by ad hoc tribunals interpreting and applying those treaties in disputes between investors and states.<sup>1</sup>

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<sup>1</sup> There is a debate about whether a “regime” or “system” actually exists given that international

Importantly, this new regime is one-sided in two important respects: first, it allows covered investors to sue governments but generally does not allow governments to initiate disputes to sue investors. Second, its protections only permit challenges to government actions (or omissions) that harm investments, thus skewing in a direction that puts pressure on government regulation.<sup>2</sup> These two factors – combined with the high costs of arbitration, the potentially large damages awards tribunals may render if they find states liable for treaty breach, and the limited avenues open to states to challenge adverse awards – make these investment treaties powerful instruments with significant consequences for states.

The stakes are particularly high for government efforts to use foreign investment as a strategy for implementing industrial policy. Investors have used investment treaties to successfully challenge a range of government conduct inherent in investment enticement, approval, and operation. Tribunals deciding treaty-based investor-state disputes have determined that governments have violated investment treaties through action taken to:

- encourage and admit investment in infrastructure and the extractive industries;
- leverage those investments for long-term, broad-based sustainable development;
- refine the legal and regulatory framework over time to adjust to changing circumstances and needs; and
- administer regulatory schemes in such areas as environmental protection, taxation, and pricing for infrastructure services.

A key message arising from these cases is that good faith conduct consistent with domestic law can still give rise to treaty liability. When a tribunal evaluates an investor's claim that the host state has breached an investment treaty, domestic law does not govern the dispute. Issues of deference, standards of proof, standards of liability, and rules on damages all become unhinged from the host country's legal system, and are resolved instead under the rules and mechanisms established by the treaty.<sup>3</sup> Those treaty rules and mechanisms, in turn, are often vaguely stated and have been subjected to diverse interpretations by commentators and tribunals, making it

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<sup>2</sup> There are potential cases where cases could encourage public interest regulation rather than limit it. An action by a foreign investor challenging government support of an anti-competitive enterprise in violation of the government's own competition laws could, for example, be used to encourage effective government regulation.

<sup>3</sup> The fact that international standards can and do trump domestic law inconsistent with those standards is, alone, not surprising in the realm of international law. But what is surprising is that when deciding whether and how international treaty standards should override domestic law, and what damages to order, tribunals do not always accord states the deference typically said to be a feature of international law, much less the level of deference common for reviewing allegations of harms to economic interests of business entities, as opposed to violations of the cogens rights and non-derogable rights of individuals. See, e.g., Caroline Henckels, *Balancing Investment Protection and Sustainable Development in Investor-State Arbitration: The Role of Deference* in *Yearbook on International Investment Law and Policy 2012-2013* (Oxford University Press, forthcoming 2014) (discussing standards of review applied by tribunals in treaty-based investor-state arbitrations).

difficult to understand *ex ante* just what the treaty means and how to avoid and defend against claims of breach.

This paper seeks to address some of those issues by illustrating how tribunals have judged state actions and omissions in connection with encouraging, admitting and regulating investments. The aim is not to say what the law *is*, but to illustrate what it has been interpreted to be, and how it therefore might be interpreted in future disputes.

The cases highlighted are those with particularly significant implications for industrial policy and sustainable development – namely, investments in infrastructure and the extractive industries. The issues focused on are liability for government conduct (1) in connection with tenders and negotiations; (2) when responding to questions regarding the legality of the investment; (3) in using performance requirements to leverage benefits and capture spillovers from the investment; (4) changing the legal framework governing an investment in response to evolving needs, circumstances, and interests; (5) administering the investment; and (6) requesting, and responding to requests for, renegotiation.

Following the cases, this paper concludes by outlining options for addressing and minimizing tensions between investment treaties and industrial policy.

## II. TENDERS AND NEGOTIATIONS

### *PSEG V. TURKEY*:<sup>4</sup> STATE LIABILITY FOR FAILED NEGOTIATIONS

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Governments engaging with private entities for investment in extractives, infrastructure, or other projects commonly select their partners and frame the deal through tenders, direct negotiations, or a combination of the two. Investors often expend significant time and resources engaging in those processes even though there is a risk that their bids will be rejected or the negotiations will collapse.

Domestic law sometimes provides unsuccessful bidders with avenues to challenge government's decision.<sup>5</sup> Negotiating parties might also enter into pre-contractual agreements to provide compensation for costs incurred in trying to conclude a deal.<sup>6</sup> But if there is an investment treaty in place, investors need not be limited by those avenues of relief. Tribunals have allowed investors to recover costs expended in pre-contract and pre-project phases, and, in some cases,

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<sup>4</sup> *PSEG v. Turkey*, ICSID Case No. ARB/02/5, Award, January 19, 2007.

<sup>5</sup> See generally, UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects (2001), paras. 127-131.

<sup>6</sup> See, e.g., *F-W Oil Interests, Inc. v. Trinidad and Tobago*, ICSID Case No ARB/01/14, Award, March 3, 2006 (referring to the claimant's attempt to secure such an agreement from the government, and to principles in the domestic law of some jurisdictions that might, in some circumstances, provide compensation for expenses incurred in connection with pre-project activities).

have even allowed investors to recover future lost profits they argue they would have recovered if they had been selected for the project.<sup>7</sup>

*PSEG v. Turkey* is an example. In that case, the investor proposed development of a mining and power plant project, and submitted a feasibility study to the Ministry of Energy and Natural Resources in order to proceed with those plans. The Ministry of Energy and Natural Resources approved the study and, in August 1996, initialed an “Implementation Contract” with PSEG and submitted that agreement for approval by the Turkish Council of State as required under domestic law.

While awaiting approval of the contract, however, PSEG was also seeking to alter the nature of the project. One fundamental issue was that PSEG had revised its mining plan after submitting the feasibility study, and those revisions resulted in increased costs for the mine that PSEG then hoped to recover through increasing the government’s obligations to purchase power from PSEG’s proposed plant. Additionally, PSEG proposed restructuring the investment through a different corporate vehicle based outside Turkey, with the new approach designed to free it from having to pay over USD 250 million in taxes to Turkey over the life of the project.

In March 1998, the Turkish Council of State approved the Implementation Contract in largely the form it had originally been submitted – i.e., based on the original feasibility study. The project, however, remained stalled as the parties had still not reached agreement on key elements necessary for it to go forward. In light of PSEG’s revised mine plan and the new economics of the project, central issues remained unsettled such as the plant’s generating capacity, the required government take, the company’s corporate form, and appropriate tariffs.

A few crucial shifts and triggers seem to have exacerbated disagreements between the parties. For one, Turkey appeared increasingly skeptical of the project’s benefits, and was concerned about the nature and extent of the financial obligations it would be assuming in favor of PSEG if required to purchase power from the plant under the terms sought by the investor. Additionally, after the tax law was changed to remove the roughly USD 250 million tax burden associated with incorporation of the project company in Turkey, PSEG nevertheless continued to demand compensation for those alleged tax payments even though it no longer had to make them. Another point of tension arose when, after PSEG sought the Ministry of Mines’ approval to change the nature of its contract from a concession contract to a private law contract (allowing the investor access to arbitration), the Ministry of Mines indicated it would only support PSEG’s request if other aspects of the Implementation Contract were renegotiated and agreed.

Ultimately, the points of contention became intractable and brought the collapse of the negotiations. PSEG then responded by initiating arbitration under the investment treaty between Turkey and the United States, seeking as damages invested costs and lost future profits from the project.

The tribunal found in favor of PSEG, determining that Turkey’s conduct violated the treaty’s fair and equitable treatment (FET) standard. In reaching that conclusion, it adopted an approach giving investors significant pre-contractual rights that translate into significant host-state

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<sup>7</sup> See *Joseph Charles Lemire v. Ukraine*, ICSID Case No. ARB/06/18, Award, March 28, 2011.

obligations. The language is worth quoting in order to illustrate the tribunal's view of just what the FET obligation requires:

*246. The Tribunal is persuaded ... that the fair and equitable treatment standard has been breached, and that this breach is serious enough as to attract liability. Short of bad faith, there is in the present case first an evident negligence on the part of the administration in the handling of the negotiations with the Claimants. The fact that key points of disagreement went unanswered and were not disclosed in a timely manner, that silence was kept when there was evidence of such persisting and aggravating disagreement, that important communications were never looked at, and that there was a systematic attitude not to address the need to put an end to negotiations that were leading nowhere, are all manifestations of serious administrative negligence and inconsistency. The Claimants were indeed entitled to expect that the negotiations would be handled competently and professionally, as they were on occasion.*

*247. Secondly, there is a breach of the obligation to accord fair and equitable standard of treatment in light of abuse of authority, evidenced in particular, but not exclusively, by the discussion of [PSEG's application to convert the contract to a private law contract]. As noted above, MENR's demands for a renegotiation went far beyond the purpose of the Law and attempted to reopen aspects of the Contract that were not at issue in this context or even within MENR's authority.*

*248. Inconsistent administrative acts are also evident in this case in respect of some matters. ... A witness for the Claimants testified that since 1996 "the various groups determining energy policy in Turkey have not worked harmoniously."*

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*250. Thirdly, the Tribunal also finds that the fair and equitable treatment obligation was seriously breached by what has been described above as the "roller-coaster" effect of the continuing legislative changes. This is particularly the case of the requirements relating, in law or practice, to the continuous change in the conditions governing the corporate status of the Project, and the constant alternation between private law status and administrative concessions that went back and forth. This was also the case, to a more limited extent, of the changes in tax legislation.*

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*254... Stability cannot exist in a situation where the law kept changing continuously and endlessly, as did its interpretation and implementation. While in complex negotiations, such as those involved in this case, many changes will occur beyond the control of the government, as was particularly the case with the increased costs, the issue is that the longer term outlook must not be altered in such a way that will end up being no outlook at all. In this case, it was not only the law that kept changing but notably the attitudes and policies of the administration.*

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*256. Even if all the above conduct were to comply with good faith, which the Tribunal has no reason not to believe, there still would be an evident breach of the fair and equitable treatment standard under the Treaty, and under Turkish law. To the extent that this caused damage, compensation will of necessity be awarded.*

The tribunal's decision thus imposed treaty liability on Turkey for "negligent" or inattentive conduct during contract negotiations, and for changes in background law and policy impacting a project even before the essential terms of that project had been agreed (due to investor-requested changes to the original Implementation Contract). The PSEG decision instructs that governments may be penalized for letting negotiations drag on when they are ambivalent about projects, and that they might also be found to breach their treaty obligations when shifting policies and growing concerns about the costs and benefits of a deal cause them to walk away from talks even though they had yet to crystallize into an agreement.<sup>8</sup>

As damages, the tribunal ordered the government to compensate the investor for costs expended from the submission of its feasibility study through continued negotiations in the effort to develop the project. All expenses were entirely pre-construction, many pre-Implementation Contract, and many were also prior to the Turkish Council of State's approval of the Concession Contract. In all, the tribunal declared that Turkey had to pay PSEG USD 9 million plus interest, and bear 65% of the roughly USD 21 million in arbitration costs.

Other relevant disputes include *Lemire v. Ukraine*<sup>9</sup> (tenders for radio broadcasting frequencies); *Parkerings v. Lithuania*<sup>10</sup> (tender for development and operation of parking infrastructure and operations); *F-W Oil v. Trinidad and Tobago*<sup>11</sup> (tenders and negotiations for a contract to develop offshore oil resources); and *Nordzucker v. Poland*<sup>12</sup> (negotiations for purchase of state-owned companies through privatization process); *Mihaly v. Sri Lanka*<sup>13</sup> (negotiations for development of power plant).

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<sup>8</sup> See also *id.*, paras. 179-186.

<sup>9</sup> Joseph Charles Lemire v. Ukraine, ICSID Case No. ARB/06/18, Award, March 28, 2011.

<sup>10</sup> Parkerings-Compagniet AS v. Republic of Lithuania, ICSID Case No. ARB/05/8, Award, Sept. 11, 2007.

<sup>11</sup> F-W Oil Interests, Inc. v. Trinidad and Tobago, ICSID Case No ARB/01/14, Award, March 3, 2006.

<sup>12</sup> Nordzucker v. Poland, Partial Award, December 10, 2008; Second Partial Award, January 28, 2009; and Third Partial and Final Award, November 23, 2009.

<sup>13</sup> Mihaly v. Sri Lanka, ICSID Case No. ARB/00/2, Award, March 15, 2002.

### III. ILLEGAL INVESTMENTS

#### *RDC V. GUATEMALA*<sup>14</sup> AND *KARDASSOPOULOS V. GEORGIA*<sup>15</sup>: LIMITING THE GOVERNMENT'S ROLE TO CHALLENGE ILLEGALITY OF CONTRACT

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Governments sometimes face the problem that they have authorized an investment or entered into an investment agreement, but have done so based on fraud or misrepresentations by the investor, or through corrupt, illegal, or *ultra vires* acts of the government. In some jurisdictions, investment authorizations or agreements infected with these issues are deemed void *ab initio*, are voidable, or are deemed unenforceable.

In the case of illegal or *ultra vires* acts by the government, jurisdictions may deem contracts void or unenforceable even though applying that rule may effectively penalize the investor not only for improper conduct by the government in which the investor was similarly complicit (e.g., in the case of corruption), but also in circumstances when the government was acting illegally or outside the scope of its authority, and the investor was unaware (perhaps negligently so) of the legal issues with its investment.

Some countries apply a strict rule against recognizing or enforcing these defective contracts even if the investor was an innocent party misled by the government, and irrespective of whether the government was knowingly or negligently at fault. A rationale behind this approach is that assessing financial responsibility against the government for improper or unauthorized actions of its officials would have the undesirable policy outcome of penalizing the public for that wrongful conduct.

Tribunals, however, have adopted a different rule, determining that if the state or a state-owned entity were involved in or aware of the illegality of a particular investment agreement, that fact would preclude the government from later arguing that the illegality rendered the agreement null and void. This issue arose in *Kardassopoulos v. Georgia*.<sup>16</sup> In that case, the tribunal determined that the underlying contracts for development of petroleum resources and related infrastructure appeared to have been entered into through *ultra vires* acts of state-owned enterprises and to be void *ab initio* under Georgian law. It concluded, however, that illegality of the contracts under domestic law did not prevent it from taking jurisdiction over a dispute arising out of alleged contract rights. It reasoned:

*[E]ven if the [Joint Venture Agreement] and the Concession were entered into in breach of Georgian law, the fact remains that these two agreements were “cloaked with the mantle of Governmental authority”. Claimant had every reason to believe that these agreements were in accordance with Georgian law, not only because they were entered into by Georgian State-owned entities, but also because their content was approved by Georgian Government officials without objection as to their legality on the part of Georgia for many years thereafter. Claimant therefore had a legitimate expectation that*

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<sup>14</sup> *RDC v. Guatemala*, Second Decision on Objections to Jurisdiction, ICSID Case No. ARB/07/23, May 18, 2010.

<sup>15</sup> *Kardassopoulos v. Georgia*, ICSID Case No. ARB/05/18, Decision on Jurisdiction, July 6, 2007.

<sup>16</sup> *Kardassopoulos v. Georgia*, ICSID Case No. ARB/05/18, Decision on Jurisdiction, July 6, 2007.

*his investment in Georgia was in accordance with relevant local laws. Respondent is accordingly estopped from objecting to the Tribunal's jurisdiction ratione materiae under the ECT and the BIT on the basis that the JVA and the Concession could be void ab initio under Georgian law.*<sup>17</sup>

The tribunal in *RDC v. Guatemala* adopted a similar approach. In that dispute, the respondent state had argued that the private investor's contracts for development and operation of railways in the country were invalid under domestic law as they were not secured through public bidding as required, and had not received the necessary congressional or presidential approvals. That illegality, Guatemala contended, prevented the contracts from qualifying as covered "investments" made pursuant to domestic law as required by the treaty.<sup>18</sup> The tribunal rejected those arguments on grounds of fairness. It said:

*146. Even if FEGUA's actions [as the government entity entering into the contracts] ... were ultra vires (not "pursuant to domestic law"), "principles of fairness" should prevent the government from raising "violations of its own law as a jurisdictional defense when [in this case, operating in the guise of FEGUA, it] knowingly overlooked them and [effectively endorsed an investment which was not in compliance with its law."*

*147. Based on these considerations the Tribunal finds that Respondent is precluded from raising any objection to the Tribunal's jurisdiction on the ground that Claimant's investment is not a covered investment under the Treaty or the ICSID Convention.*<sup>19</sup>

This limitation to the legality requirement is notable in that would effectively override some countries' legal and policy decisions to strictly prevent enforcement of illegal contracts or contracts secured through ultra vires conduct. Due to the difficulties of rooting out corruption or other impropriety, rules against enforcement can act as prophylactic measures preventing such wrongful and usually opaque conduct. Furthermore, strengthening the force of those rules, at least some jurisdictions do not allow private entities to use doctrines of reliance or estoppel to avoid their potentially harsh effects.<sup>20</sup> As Guatemala thus argued in *RDC*, binding governments to illegal, ultra vires, or improperly secured contracts could "severely and improperly restrict State sovereignty. Taken to the extreme, a bright-line rule that a State is estopped from exercising pre-existing domestic remedies to question the validity of a contract simply because

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<sup>17</sup> *Id.* at para. 194.

<sup>18</sup> *RDC v. Guatemala*, Second Decision on Objections to Jurisdiction, ICSID Case No. ARB/07/23, May 18, 2010, para. 140 (quoting CAFTA, art. 10.28(g)).

<sup>19</sup> *RDC v. Guatemala*, Second Decision on Objections to Jurisdiction, ICSID Case No. ARB/07/23, May 18, 2010, paras. 146-47 (quoting *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines*, ICSID Case No. ARB/03/25, Award, August 16, 2007, para. 346).

<sup>20</sup> In the United States, see, e.g., *Office of Personnel Management v. Richmond*, 496 U.S. 419 (1990); *Fed. Crop. Ins. Corp. v. Merrill*, 332 U.S. 380 (1947).



the State had operated under that contract for a period of time could prevent a State from terminating a contract initiated by bribery or corruption.”<sup>21</sup>

Other relevant disputes on the impact of the legality of investments include *Inceysa v. El Salvador*<sup>22</sup> (finding no jurisdiction over investment secured through fraud), *Metal Tech v. Uzbekistan*<sup>23</sup> (rejecting jurisdiction over investment made through corruption), and *Vanessa Ventures v. Venezuela*<sup>24</sup> (determining it had jurisdiction over an investment even though it was made in breach of the contract).

#### IV. LEVERAGING INVESTMENTS FOR SUSTAINABLE DEVELOPMENT

##### *MOBIL V. CANADA*:<sup>25</sup> BROAD PROHIBITIONS ON PERFORMANCE REQUIREMENTS WITH ONLY NARROW EXCEPTIONS

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Some disputes address the legality of government efforts to leverage investments for sustainable development through the imposition of performance requirements. One such case is *Mobil v. Canada*, a decision potentially signaling where future cases could head.

The dispute arose out of the following facts: In the late 1970s, when oil fields were discovered off the coast of Newfoundland, Canada, the federal and provincial governments recognized the opportunity that the discovery provided for catalyzing long-term sustainable growth and development in the country. They put in place a legal regime designed to achieve that aim, enacting the 1987 “Accord Act” to, among other objectives, require investors engaging in development of the offshore resources to make “expenditures ... for research and development” (R&D) and “for education and training” (E&T) in the local province.<sup>26</sup>

In the mid-1990s, Canada concluded the North American Free Trade Agreement (NAFTA) with the United States and Mexico, which contains restrictions on performance requirements (such as requirements to procure services locally) in its investment chapter. Canada listed the Accord Act as an exception to the treaty’s restrictions on performance requirements. The NAFTA also included within that exception any “subordinate measure adopted or maintained under the authority of and consistent with the [Accord Act].”

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<sup>21</sup> *RDC v. Guatemala*, ICSID Case No. ARB/07/23, Award, June 29, 2012, para. 197 (quoting Guatemala’s Rejoinder on the Merits, October 21, 2011, para. 185).

<sup>22</sup> *Inceysa Vallisoletana S.L. v. El Salvador*, ICSID Case No. ARB/03/26, Award, Aug. 2, 2006.

<sup>23</sup> *Metal Tech Ltd. v. Republic of Uzbekistan*, ICSID Case No. ARB/10/3, Award, October 4, 2013.

<sup>24</sup> *Vanessa Ventures v. Venezuela*, ICSID Case No. ARB(AF)/04/6, Award, Jan. 16, 2013.

<sup>25</sup> *Mobil Investments Canada, Inc. v. Canada*, ICSID Case No. ARB(AF)/07/4, Decision on Liability and on Principles of Quantum, May 22, 2012.

<sup>26</sup> *Mobil v. Canada*, para. 37 (citing the Accord Acts, section 45).

Pursuant to the Accord Act, the Canadian government issued a series of guidelines in the 1980s relating to investors' obligations on R&D and other matters. Then, in 2004, Canadian officials issued new guidelines under the Accord Act which imposed additional and stronger requirements on investors in the offshore oilfields to invest in R&D and E&T.

Mobil objected to the guidelines and challenged them under Canadian law. After losing their suit before domestic courts, the claimants initiated an investor-state arbitration under the NAFTA arguing, in relevant part, that the new guidelines' heightened requirements to invest in R&D violated the NAFTA's prohibitions on performance requirements.

Canada responded that the performance requirements were not prohibited by the treaty because the restrictions on performance requirements did not cover measures requiring R&D or E&T. Canada also argued that if the guidelines were deemed to constitute performance requirements, they were nevertheless covered by the government's exception for the Accord Act and its subordinate measures.

The tribunal, however, sided with Mobil on both issues. It decided that the NAFTA's prohibition on requirements to procure services locally included a prohibition on requirements for local R&D and E&T. It then determined that the new and more demanding guidelines departed from previous practice to such an extent that they could not be deemed to fall within Canada's exception to the NAFTA for the Accord Act and its subordinate measures.

Importantly, through these interpretations, the majority adopted a broad view of prohibited performance requirements and a narrow view of exceptions to treaty provisions protecting use of those tools.

## V. RENEGOTIATION REQUESTS

### *MISCELLANEOUS CASES: REQUIREMENTS TO RESPOND TO RENEGOTIATION REQUESTS AND RESTRICTIONS ON INITIATING THEM*

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International contracts – particularly those running over long time horizons such as contracts for investments in infrastructure or the extractive industries – are often renegotiated. Some of these renegotiations are “intra-deal renegotiations”, meaning that the contract itself provides that certain parts of the agreement may or will be renegotiated at specified times or in certain circumstances.<sup>27</sup> The renegotiation takes place in accordance with the original contract.<sup>28</sup> An example is a clause requiring a periodic review of tariffs charged for water or electricity, or a clause providing for an extraordinary review of those tariffs in the event of particular events or

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<sup>27</sup> Jeswald Salacuse, *Renegotiating International Business Transactions: The Continuing Struggle of Life Against Form*, 35 *Int'l Law* 1507, 1508-1509 (2001).

<sup>28</sup> *Id.*

circumstances. These provisions aim to inject flexibility into the deal in order to enable it to survive over time and under changing circumstances.<sup>29</sup>

Other renegotiations are “extra-deal renegotiations”:

*These negotiations take place “extra-deal,” for they occur outside the framework of the existing agreement. Forced renegotiation of mineral concession contracts of the 1960s and 1970s, negotiations to reschedule loans following the Third World debt crisis of the early 1980s, and the restructuring of infrastructure and financial agreements in the wake of the Asian financial crisis of the late 1990s all fit within the category of extra-deal renegotiations. In each case, one of the participants was seeking relief from a legally binding obligation without any basis for renegotiation in the agreement itself.*<sup>30</sup>

Each type of renegotiation has figured as an issue in investment disputes, with tribunals’ decisions having noteworthy implications for states’ conduct in connection with both intra-deal and extra-deal talks.

## INTRA-DEAL RENEGOTIATIONS

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Several cases indicate that, irrespective of what the contract or relevant domestic law provides, treaties may impose an additional layer of obligations and potential liability on governments relating to their conduct in pursuing or responding to requests for intra-deal renegotiations.

In *PSEG v. Turkey*, as noted above, the tribunal signaled that investors are “entitled to expect that [their] negotiations [will] be handled competently and professionally,” and that there will be a breach of the FET obligation if those expectations are not met.<sup>31</sup> In *Saluka v. Czech Republic*, the tribunal stated that the treaty’s FET provision required the state to “take[] seriously a proposal that has sufficient potential to solve the [relevant] problem and deal with it in an objective, transparent, unbiased and even-handed way.”<sup>32</sup> Citing those two decisions, the tribunal in *Frontier Services v. Czech Republic* declared that the requirement of good faith was central to the FET standard and that a failure to negotiate in good faith would thus violate the treaty obligation.<sup>33</sup> It added that liability could still attach even if the state were not acting in bad faith.<sup>34</sup>

In *Teco v. Guatemala*, the tribunal stated that a lack of administrative due process in an inter-deal tariff review processes would violate the FET obligation.<sup>35</sup> An administrative body’s failure to provide reasons supporting its decisions, or to abide by its own procedural rules were factors that the tribunal viewed as establishing a lack of administrative due process and, consequently,

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<sup>29</sup> For more on intra-deal renegotiations, see Salacuse, *supra* n. 28, at 1513-1518.

<sup>30</sup> *Id.* at 1509.

<sup>31</sup> *PSEG v. Turkey*, para. 246.

<sup>32</sup> *Saluka v. Czech Republic*, para. 364.

<sup>33</sup> *Frontier Services v. Czech Republic*, paras. 297-300.

<sup>34</sup> *Frontier Services v. Czech Republic*, para. 300.

<sup>35</sup> *Teco v. Guatemala*, para. 457.

a treaty breach.<sup>36</sup> The tribunal added that the facts that those alleged failings had already been challenged before Guatemalan courts, that those courts had upheld the legitimacy of the government's conduct under Guatemalan law, and that there was no indication or allegation of a denial of justice or corruption in those judicial proceedings, did not prevent the tribunal from taking jurisdiction over the dispute and deciding whether the government's conduct violated international law under the treaty.<sup>37</sup> According to the tribunal, findings of procedural propriety under Guatemalan law were not binding on it as a matter of law. It reasoned that the outcome in the project company's suit against the regulator under domestic law could not determine the outcome of the minority shareholder's suit against Guatemala under the treaty as the different cases involved different parties and different legal standards.<sup>38</sup>

Ultimately, the tribunal determined that Guatemala violated the investment treaty when it decided to rely on one expert report regarding appropriate tariff calculations rather than another expert report, and, according to the tribunal, did not provide adequate reasons for its choice.

Some cases indicate that treaty-based obligations to renegotiate are obligations regarding *results* that are binding on the government, rather than merely obligations as to process or efforts. In *Impregilo v. Argentina*,<sup>39</sup> the tribunal determined that the government breached the FET obligation by not renegotiating the water and sanitation services concession in order to restore the economic equilibrium of the contract in response to the economic crisis in the country and the decision by the government to de-peg the peso from the dollar and establish a floating exchange rate. The tribunal reasoned:

*325. The Arbitral Tribunal considers that, once the value of the peso was determined by market conditions, the balance provided for in Article 12.1.1 [setting forth the principles on which tariffs would be calculated]<sup>40</sup> no longer existed and that, according to Article 12.1.1, it was then incumbent on the Province, in order to treat AGBA in a fair and equitable manner, to find appropriate solutions to restore the envisaged balance. In other words, since the new exchange rate caused by the abolition of the fixed legal rate had highly detrimental effects on AGBA, the Province should have offered AGBA a reasonable adjustment of its obligations under the Concession Contract.*

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<sup>36</sup> *Id.*

<sup>37</sup> *Teco v. Guatemala*, paras. 471-484.

<sup>38</sup> *Teco v. Guatemala*, para. 517.

<sup>39</sup> *Impregilo S.p.A. v. Argentina*, ICSID Case No. ARB/07/17, Award, June 21, 2011.

<sup>40</sup> Article 12.1.1 provided " '[t]he calculation of applicable tariffs pursuant to Article 28 II of Law 11,820 shall be based on the general principle that tariffs shall cover all operating expenses, maintenance expenses and service amortization and provide a reasonable return on Concessionaire's investment subject to efficient management and operation by the Concessionaire and strict compliance with the applicable service quality and expansion goals'." *Impregilo v. Argentina*, para. 324.

326. Indeed, it appears that the Emergency Law also envisaged a renegotiation of public utilities agreements to adapt them to the new exchange system. This would have been a basis for finding a new equilibrium between the Parties to the Concession Agreement and for ensuring that Impregilo, as shareholder in AGBA, was granted fair and equitable treatment.

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330. Since the disturbance of the equilibrium between rights and obligations in the concession was essentially due to measures taken by the Argentine legislator [in establishing the floating exchange rate and regulating water and sewerage services], it must have been incumbent on Argentina to act to effectively restore an equilibrium on a new or modified basis. Although Argentina has attributed the failure of the negotiations to what it regarded as AGBA's unreasonable demands, it does not appear that Argentina took any measures to create for AGBA a reasonable basis for pursuing its tasks as concessionaire which had been negatively affected by the emergency legislation, including the New Regulatory Framework.

331. In these circumstances, the Arbitral Tribunal considers that Argentina, by failing to restore a reasonable equilibrium in the concession, aggravated its situation to such extent as to constitute a breach of its duty under the BIT to afford a fair and equitable treatment to Impregilo's investment.<sup>41</sup>

The tribunal's decision thus seems to read the FET obligation as imposing a duty on the government to not only offer or engage in a renegotiation effort, but to secure an outcome fair to the investor "restor[ing] a reasonable equilibrium in the concession." Yet where, as in *Impregilo*, the claimant in the treaty dispute is a minority shareholder in the domestic concessionaire, and that the concessionaire is not a party to the treaty-based dispute before the tribunal, it likely becomes particularly difficult to identify whether the failure to restore equilibrium was due to conduct of the government, the concessionaire, or both parties.

Moreover, in this case a duty to successfully renegotiate the contract would likely have been particularly challenging due to the fact that the government – even prior to the country's financial crisis and currency devaluation – had been facing various requests by the concessionaire to renegotiate the deal by reducing its investment commitments and service obligations, and might have wanted to avoid counterproposals it was unwilling to accept. Indeed, as the tribunal noted in support of its finding of liability, the government appeared "reluctant to renegotiate the Concession Contract" and was concerned about making "adjustments in favor of the [concessionaire] ... as this would have negative effects for the customers whose economic interests required protection."<sup>42</sup> In such circumstances, one can perceive, as Argentina contended, that the failure of renegotiations may have been due at least

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<sup>41</sup> *Impregilo v. Argentina*, paras. 325-331.

<sup>42</sup> *Impregilo v. Argentina*, para. 329.

in part to the concessionaire's demands being unreasonable.<sup>43</sup> Nevertheless, under the tribunal's interpretation of the treaty's rule, it appears that the government is subject to demands, standards and attendant potential liabilities that do not similarly apply to concessionaires, much less the minority shareholders in those companies.

The familiar caveat to these decisions and any conclusion regarding them again applies: Briefs and decisions by courts and tribunals demonstrate that not all states, arbitrators, or reviewing judges agree that the FET obligation incorporates these requirements of good faith, transparency, or administrative due process whether in intra-deal reviews or renegotiations, or other circumstances. The cases highlighted here are not used to show what the law is, but what the decision might be, lest any state be unsure what potential liability arises as a result of investment treaties.

## EXTRA-DEAL RENEGOTIATIONS

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Extra-deal renegotiations involve intense challenges and pressures, not least because they are usually unwanted by one party:

*Unlike negotiations for the original transaction, which are generally fueled by both sides' hopes for future benefits, extra-deal negotiations begin with both parties' shattered expectations. One side has failed to achieve the benefits expected from the transaction, and the other is being asked to give up something for which it bargained hard and which it hoped to enjoy for a long time. Whereas both parties to the negotiation of a proposed new venture participate willingly, if not eagerly, one party always participates reluctantly, if not downright unwillingly, in an extra-deal renegotiation. Beyond mere disappointed expectations, extra-deal renegotiations, by their very nature, can create bad feeling and mistrust. One side believes it is being asked to give up something to which it has a legal and moral right. It views the other side as having gone back on its word, as having acted in bad faith by reneging on the deal. Indeed, the reluctant party may even feel that it is being coerced into participating in extra-deal renegotiations since a refusal to do so would result in losing the investment it has already made in the transaction.<sup>44</sup>*

These characteristics of extra-deal renegotiations are evident in and important for considering treaty-based investor-state arbitration. This is primarily because if the investor is the unwilling party that feels unfairly forced to renegotiate, it can seek treaty-based relief by threatening or pursuing investor-state arbitration. By pursuing this avenue, the investor can try to convince its state counterparty not to pursue extra-legal renegotiation; and, if the state insists, the investor can seek compensation for any costs it is asked to incur, thereby undoing if not mitigating the consequences of the renegotiation.

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<sup>43</sup> *Id.* para. 330.

<sup>44</sup> Salacuse, *supra* n. 28, at 1518.

Alternatively, if the investor seeks renegotiation, the government has no recourse under the investment treaty. Investment treaties give investors, not states, protections and the ability to initiate investor-state disputes.

This asymmetry can put states at a significant disadvantage vis-à-vis their contracting parties, creating scenarios in which they may be brought back to the negotiating table against their will in order to save a deal, while their own ability to force investors to renegotiate aspects of the agreement is weakened. This is especially important given that studies have shown investors – not states – are commonly the drivers for extra-legal renegotiations. Indeed, one review of 1,000 concession contracts in the telecommunications, transportation, water and sanitation services, and electricity sectors that were awarded in Latin America and the Caribbean between the mid-1980s and 2000 found that extra-legal renegotiations were “extremely common”<sup>45</sup> and in 61 percent of those renegotiations, the renegotiations were requested by the concessionaire or operator. In 26 percent the government initiated the renegotiation. The remaining cases consisted of those in which both the concessionaire and the government sought renegotiation.<sup>46</sup>

That study shows that firm-led renegotiations are particularly common in cases where the contract was awarded through competitive bidding as opposed to direct negotiations. This, researchers explain, appears to reflect the fact that investors are able to secure contracts by underbidding (e.g., on tariffs) or overbidding (e.g., on payments to the government and investment contributions), with the intent or effect of subsequently opportunistically renegotiating the deal. In contrast, when securing the contract through direct negotiations, investors are more likely to “secure all the benefits or rents at the start, making renegotiation unnecessary from the operator’s perspective.”<sup>47</sup>

Investors are also more likely to seek renegotiation when the contract is structured in a way that the risk of changes in circumstances and adverse events are born by them (e.g., through a price-cap system of regulating tariffs) rather than the government (e.g., through a rate-of-return method),<sup>48</sup> and when the government is susceptible to renegotiation, which may be due to such factors as capture or corruption, or lack of regulatory strength and capacity to resist opportunistic renegotiation requests.<sup>49</sup>

Once renegotiation is sought, investors have strong power to get states back to the negotiating table:

*[T]he operator has significant leverage, because the government is often unable to reject renegotiation and is usually unwilling to claim failure—and let the operator abandon the*

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<sup>45</sup> Guasch, p. 81. According to the study, 30 percent of these concessions were renegotiated. Among the concession contracts for water and sanitation services, that number was 74 percent, and for transportation contracts, 55 percent. The study did not count as renegotiations standard, scheduled tariff adjustments or periodic tariff reviews. *Id.* at 80.

<sup>46</sup> Guasch, pp. 84-85

<sup>47</sup> Guasch, p. 92.

<sup>48</sup> Guasch, p. 91.

<sup>49</sup> Guasch, pp. 91-94.

*concession—for fear of political backlash and additional transaction costs. In such cases the operator, through renegotiations, can undermine all the benefits of the bidding- or auction- led competitive process.*<sup>50</sup>

Thus, although discussions about foreign investment in infrastructure and other capital intensive projects frequently mention the phenomenon of the “obsolescing bargain” in which an investor with significant fixed assets in the host country becomes hostage to government power and discretion,<sup>51</sup> the dominance of this narrative obscures a different reality – one in which the government is held hostage to opportunistic renegotiations.

Against that background, it is especially crucial to review how tribunals have treated extra-legal renegotiations; and the cases suggest governments have significant cause for concern that these decisions may greatly tilt the balance of power in favor of investors even where investors already enjoy important leverage. In particular, investment treaties seem to erect an important shield around investors protecting them from government attempts to renegotiate agreements, while placing pressure on governments to come back to the table when requested by the investor.

### ***Government-led Renegotiations***

Various investment disputes have arisen precisely out of a scenario in which the change was requested by the government, putting the investor in the position of the reluctant renegotiator. In response, investors have used investment arbitration (or the threat of arbitration) to challenge government efforts to “pressure” them to renegotiate deals.

Investors have succeeded on these claims, with at least some tribunals finding that governments violate the investment treaties when trying to get their contracting party to renegotiate their deal.<sup>52</sup> The motives and methods used to secure renegotiations have also been relevant to tribunals’ views on liability, as investors – with varying degrees of success – have argued that governments’ “political” motives and/or exercises of sovereign powers are key factors supporting treaty breach.

One case highlighting these issues is *Vivendi v. Argentina II*, in which the tribunal concluded that government officials in an Argentine province breached the investment treaty by improperly pressuring the concessionaire to renegotiate the agreement.

In that case, even before the concession was awarded, there was notable opposition to the privatization of the water services at the heart of the dispute; and after transfer to the concessionaire, that opposition escalated, fueled by a number of factors, including a change in government, the concessionaire’s doubling of tariffs charged, lack of certainty among residents and governments about the conditions of the concession and terms of the contract, and major problems in delivery of water, including incidents of red turbidity over the course of one to two

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<sup>50</sup> Guasch, p. 33.

<sup>51</sup> Guasch, pp. 84-86.

<sup>52</sup> In addition to the cases discussed in this section, see also *Siemens AG v. Argentina*, ICSID Case No. ARB/02/8, Award, February 6, 2007, para. 308.



months, and black turbidity that lasted over the course of two weeks, neither of which users had previously experienced.<sup>53</sup> Media attention on the concession and its operation intensified; an independent ombudsman advised water users of their legal rights and remedies regarding issues with payment and service quality; individual legislators made comments critical of the concession and, like the ombudsman, also gave citizens information regarding their rights with respect to the concessionaire; the legislature appointed a special committee to investigate the legitimacy of the concession contract; and the Court of Accounts issued a report questioning the agreement's consistency with the law. There was, therefore, notable pressure on the government to address these concerns; prompting its requests for renegotiations of the tariff, but also contemplating that the investor would be able to reduce its investment commitments and obligations to extend service.

Reviewing these events, the tribunal concluded that the government had "mounted an illegitimate 'campaign' against the concession, the concession Agreement, and the 'foreign' concessionaire from the moment it took office, aimed either at reversing the privatization or forcing the concessionaire to renegotiate (and lower) CAA's tariff's."<sup>54</sup> The tribunal further declared that the government's "so-called regulatory activity constituted ongoing, unfair and inequitable behavior because it was no more than politically driven arm-twisting aimed at compelling Claimants to agree to new terms to the Concession Agreement which were acceptable to the new government."<sup>55</sup> Such conduct, the tribunal determined, violated the FET standard under the treaty.

The tribunal's finding of liability thus seemed to largely hinge on its view that the government's actions were motivated by "political" concerns and through public and governmental means. The tribunal highlighted the role of the individual legislators, legislature, ombudsman, concession regulator, and the governor of the province as forming part of this political "campaign" against the concessionaire and criticized the government's apparent role in harming, rather than improving, the relationship between the concessionaire and the public.

This approach raises a number of issues for governments. For one, through such a totality of the circumstances approach where liability is based on the perception of a "campaign" implemented by a variety of different actors who accountable to different individuals and groups within and outside the government, the tribunal applied a standard that can be breached even if each individual act making up that "campaign" could not or would not give rise to liability under domestic or international law.<sup>56</sup> This standard may be particularly difficult for states to

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<sup>53</sup> The tribunal downplayed these events by noting that although they were "unquestionably unpleasant" they lasted "only" about two weeks (for the black turbidity), "only" impacted a "relatively small part of the population (5-10%) (for the red turbidity), and posed no known health risks. *Vivendi v. Argentina*, para. 7.6.2. It seems questionable that users of the water were as comforted by those factors.

<sup>54</sup> *Vivendi II v. Argentina*, para. 7.4.19; see also *id.* at para. 7.4.31 & n. 355.

<sup>55</sup> *Id.* para. 7.4.38.

<sup>56</sup> *Id.* para. 7.5.29 (referring to the measures "taken cumulatively"); *id.* paras. 7.4.38-7.4.39 (referring to the regulator's conduct "against a background of" other individuals' and entities' criticisms of and questions regarding the concession);

comply with as many of the actions alleged to be wrongful here – e.g., comments to the press, communications to the public, government responses to public outcries, and legislative establishment of investigative committees – are common if not encouraged in democratic governments. Indeed, such actions as are often even given enhanced free speech protections and immunities from discovery and/or liability in order to avoid chilling them.

Moreover, the tribunal’s approach focusing on the “political” motives for the government’s efforts to renegotiate the contract fails to take into account that governments likely will by their very nature – and should be – responsive to and driven by political motives as those are ultimately driven by the needs and demands of constituents they represent, particularly when the contract relates to provision of essential public services. Just as a project company may seek renegotiation in order to satisfy shareholders, lenders or other key stakeholders to whom they owe duties, governments may seek renegotiation in order to respond to and advance the needs of the citizens to whom they are also accountable.

Other tribunals have similarly focused on the nature or mode of government conduct used to bring a private party back to the negotiating table.<sup>57</sup> In *PSEG v. Turkey*, when the claimant had sought government approval to convert its public law contract to a private law one giving it the right to arbitrate disputes, the government indicated that it would only agree to support the claimant’s application if the claimant agreed to renegotiate certain aspects of the underlying contract. The tribunal considered the government’s attempt to impose that condition an improper exercise of sovereign authority and relied on it when finding that the government had violated the treaty.<sup>58</sup>

*AES v. Hungary* is similarly critical of government efforts to use sovereign powers to encourage or “force” renegotiations:

*[I]t cannot be considered a reasonable measure [consistent with the for a state to use its governmental powers [including its power to implement laws or issue decrees] to force a private party to change or give up its contractual rights. If the state has the conviction that its contractual obligations to its investors should no longer be observed (even if it is a commercial contract, which is the case), the state would have to end such contracts and assume the contractual consequences of such early termination.*<sup>59</sup>

With respect to the motives, the *AES v. Hungary* tribunal said – in contrast to *Vivendi II* – that “political” reasons for taking action could weigh against, rather than in favor of liability. That case had centered around Hungary’s actions to address alleged excessive profits obtained by electricity generators under the country’s pricing regime. The tribunal noted that the level of the companies’ returns had become “a public issue and something of a political lightning rod in the face of upcoming elections”;<sup>60</sup> but rather than evidencing the irrationality of the government’s conduct, the political attention on the matter indicated it was a public policy topic of

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<sup>57</sup> See, e.g., *AES v. Hungary*, para. 10.3.12; *RDC v. Guatemala*, paras. 230-235.

<sup>58</sup> *PSEG v. Turkey*, para. 247.

<sup>59</sup> *AES v. Hungary*, para. 10.3.12.

<sup>60</sup> *AES v. Hungary*. 10.3.22.

widespread concern that the government could legitimately address through exercise of its lawmaking powers. If exercise (or potential exercise) of government authority had the effect of encouraging the investor to renegotiate the underlying contract then, under the AES tribunal's reasoning, that fact would not be sufficient to render the government's conduct a breach of the investment treaty.

In another departure from the *Vivendi II* approach, in *Electrabel v. Hungary*, the tribunal rejected the claimant's assertion that Hungary's actions seeking, inter alia, renegotiations of power purchase agreements, were improperly driven by "political" motives and thus violated the FET obligation.<sup>61</sup> The tribunal stated:

*There is no doubt that by late 2005 and early 2006 there was political and public controversy in Hungary over the perceived high level of profits made by Hungarian Generators, including Dunamenti. However, politics is what democratic governments necessarily address; and it is not, ipso facto, evidence of irrational or arbitrary conduct for a government to take into account political or even populist controversies in a democracy subject to the rule of law.*<sup>62</sup>

### **Firm-led Renegotiation**

Other cases have looked at government conduct in response to investor requests for extra-deal renegotiations, and have signaled that even when the government had no legal duty under the relevant contract to enter into or conclude those renegotiations, investment treaties may impose certain requirements regarding how to respond to those renegotiation requests. In *Biwater v. Tanzania*, for instance, the tribunal recognized that the government had no legal obligation under the contract to enter into the broad renegotiations sought by the water services concessionaire, but that it nevertheless decided to accommodate the concessionaire and engage in those discussions. Rather than rejecting the claimant's claim that the government was liable for its conduct in those renegotiations on the ground that the government had no duty to engage in them in the first place, the tribunal proceeded to scrutinize the government's approach to procedural and substantive aspects of those talks. It ultimately concluded that the government performed the renegotiation in good faith, was not unreasonable in its decision to require that the renegotiations be conducted within a limited timeframe,<sup>63</sup> and was also not unreasonable in its decision to reject the concessionaire's proposal or to require the concessionaire accept certain of the government's own terms.<sup>64</sup>

This decision, similar to *PSEG v. Turkey*, suggests that investors dissatisfied with the process or outcome of investor-initiated extra-deal renegotiations may be able to use investment treaties to challenge the procedures adopted and stances taken by governments in those talks, potentially providing them leverage over their government counterparty to the contract.

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<sup>61</sup> On these arguments by the claimant, see, e.g., *Electrabel v. Hungary*, paras. 7.6 and 8.8.

<sup>62</sup> *Electrabel v. Hungary*, para. 8.23.

<sup>63</sup> *Biwater v. Tanzania*, paras. 652-654.

<sup>64</sup> *Biwater v. Tanzania*, paras. 673-675.

## VI. CONCLUDING REMARKS

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As this paper illustrates, investment treaties impose vaguely worded but often broadly interpreted obligations on host states, and typically provide foreign investors a right to enforce those obligations through investor-state arbitration. Through their standards and arbitration mechanisms, these treaties can expose host countries to significant potential and actual liability, and can have profound impacts on the development and implementation of industrial and other public policies. Moreover, the long lives of the agreements and the degree to which arbitral awards are insulated against judicial review make it difficult for states to address and correct unintended and unforeseen impacts of the treaties.

While states can take a fresh look at issues regarding the optimal design of their investment treaties when negotiating *new* texts, they are more limited in terms of how they address issues that have arisen under *existing* treaties. Nevertheless, given the number of existing agreements (over 3,000 worldwide), the potentially broad obligations they impose, and their extended duration, it is crucial for states to also examine those treaties and take steps to clarify uncertainties and ambiguities so that the texts best reflect the signatory states' intent.

For existing treaties, states have three main options: (1) termination of the treaty, (2) negotiation of amendments to the treaty (or supplanting existing agreements with new ones), and (3) interpretations and clarifications of treaty provisions that must be taken into account by tribunals interpreting the treaties. All three are important to consider as part of an overall strategy for aligning investment agreements to domestic policy goals.